

REPORT OF EXAMINATION
OF THE
MERCED MUTUAL INSURANCE COMPANY
AS OF
DECEMBER 31, 2006

Filed May 27, 2008

TABLE OF CONTENTS

	<u>PAGE</u>
SCOPE OF EXAMINATION.....	1
MANAGEMENT AND CONTROL	2
TERRITORY AND PLAN OF OPERATION	3
REINSURANCE:	3
Assumed.....	3
Ceded	3
ACCOUNTS AND RECORDS	4
FINANCIAL STATEMENTS:	5
Statement of Financial Condition as of December 31, 2006	6
Underwriting and Investment Exhibit for the Year Ended December 31, 2006.....	7
Reconciliation of Surplus as Regards Policyholders from December 31, 2003 through December 31, 2006	8
COMMENTS ON FINANCIAL STATEMENT ITEMS:.....	9
Losses and Loss Adjustment Expenses	9
Taxes, Licenses, and Fees	9
Current Federal and Foreign Income Taxes	9
SUMMARY OF COMMENTS AND RECOMMENDATIONS:.....	10
Current Report of Examination.....	10
Prior Report of Examination.....	10
ACKNOWLEDGMENT.....	11

San Francisco, California
April 25, 2008

Honorable Steve Poizner
Insurance Commissioner
California Department of Insurance
Sacramento, California

Dear Commissioner:

Pursuant to your instructions, an examination was made of the

MERCED MUTUAL INSURANCE COMPANY

(hereinafter also referred to as the Company) at its home office located at 971 East Broadway, Atwater, California 95301.

SCOPE OF EXAMINATION

The previous limited scope examination of the Company was made as of December 31, 2002. This examination covers the period from January 1, 2003 through December 31, 2006. The examination included a review of the Company's practices and procedures, an examination of management records, tests and analyses of detailed transactions within the examination period, and an evaluation of the assets and a determination of liabilities as of December 31, 2006, as deemed necessary under the circumstances.

In addition to those items specifically commented upon in this report, other phases of the Company's operations were reviewed including the following areas that require no further comment: company history; corporate records; fidelity bonds and other insurance; officers', employees' and agents' welfare and pension plans; growth of company; business in force by states; loss experience; and sales and advertising.

MANAGEMENT AND CONTROL

Management of the Company is vested in an eight-member board of directors who are elected for three-year terms. As of December 31, 2006, the directors and principal officers were as follows:

Board of Directors

<u>Name and Residence</u>	<u>Principal Business Affiliation</u>
James A. Abbate Merced, California	Owner and Operator McDonald's restaurant franchises
Michael M. Brem Turlock, California	President SupHerb Farms
Bertyl W. Johnson Merced, California	Retired Partner Yosemite Farms and Johnson Orchards
Michael D. Kobane Turlock, California	President and Chief Executive Officer Merced Mutual Insurance Company
Anthony P. Medeiros, Jr. Gustine, California	General Manager The DiMare Company
Thomas K. Sperry Turlock, California	Owner and Operator Boies Medical Center Pharmacy
Angelo A. Taddeo Merced, California	Treasurer Merced Mutual Insurance Company
Darryl W. Woods Turlock, California	Retired President Woods Furniture Company

Principal Officers

<u>Name</u>	<u>Title</u>
Michael D. Kobane	President and Chief Executive Officer
Mary B. Shambaugh	Corporate Secretary
Angelo A. Taddeo	Treasurer
Donald R. Duran	Vice President of Claims

TERRITORY AND PLAN OF OPERATION

The Company has been admitted to do business as a general mutual insurer since May 14, 1982. It was a county mutual fire insurer prior to that date, and has been in operation in California since 1906. The Company is authorized to write fire, surety, plate glass, liability, burglary, and miscellaneous lines of business. The Company is only licensed in California, and has no pending applications for admission to other states.

During the examination period, the majority of the business was written in northern and central California. Major lines of business were homeowners' multiple peril, fire, and farmowners' multiple peril which accounted for 83.9%, 5.3%, and 4.1%, respectively, of the \$7.5 million in total direct premiums written in 2006.

Business is produced through approximately 92 independent agents.

REINSURANCE

Assumed

The only assumed reinsurance during the examination period was an immaterial amount from NAMIC Insurance Company, Inc. and Regional Reciprocal Catastrophe Pool.

Ceded

The following is a summary of ceded reinsurance agreements in effect as of December 31, 2006:

<u>Type of Contract</u>	<u>Reinsurer's Name</u>	<u>Company's Retention</u>	<u>Reinsurers Maximum Limits</u>
First Excess of Loss	American Reinsurance Company	\$125,000 each risk in each occurrence	\$375,000 excess of \$125,000 on each risk in each occurrence, \$1,125,000 for all risks in any one occurrence

<u>Type of Contract</u>	<u>Reinsurer's Name</u>	<u>Company's Retention</u>	<u>Reinsurers Maximum Limits</u>
Second Excess of Loss	American Reinsurance Company	\$500,000 each risk in each occurrence	\$1,500,000 excess of \$500,000 on each risk in each occurrence, \$5 million for all risks in any one occurrence
Catastrophe First Layer	American Reinsurance Company	\$300,000 per occurrence plus 5% of \$700,000 in excess of \$300,000	95% of \$700,000 per occurrence in excess of \$300,000
Catastrophe Second Layer	American Reinsurance Company	\$1 million per occurrence plus 5% of \$1 million in excess of \$1 million	95% of \$1 million per occurrence in excess of \$1 million
Catastrophe Third Layer	American Reinsurance Company	\$2 million per occurrence plus 5% of \$2 million in excess of \$2 million	95% of \$3 million per occurrence in excess of \$2 million
Catastrophe Excess of Loss	Mutual Reinsurance Bureau	\$5 million any one loss occurrence	\$5 million in excess of \$5 million on any one loss occurrence, limited to \$10 million during the term of the agreement

ACCOUNTS AND RECORDS

During the course of the examination, a review was made of the Company's general controls over its information systems and weaknesses were noted in the areas of disaster recovery/business continuity planning, data backup procedures and physical security. The weaknesses noted were discussed with the Company and it was recommended that the Company take measures to strengthen its controls. In response to the findings, the Company has taken steps to strengthen its controls.

FINANCIAL STATEMENTS

The financial statements prepared for this examination report include:

Statement of Financial Condition as of December 31, 2006

Underwriting and Investment Exhibit for the year ended December 31, 2006

Reconciliation of Surplus as Regards Policyholders from December 31, 2002
through December 31, 2006

Statement of Financial Condition
as of December 31, 2006

<u>Assets</u>	<u>Ledger and Non-ledger Assets</u>	<u>Non- Admitted Assets</u>	<u>Net Admitted Assets</u>	<u>Notes</u>
Bonds	\$ 1,655,383	\$	\$ 1,655,383	
Stocks:				
Preferred stocks	50,960		50,960	
Common stocks	7,483,456		7,483,456	
Real estate:				
Properties occupied by the company	138,143		138,143	
Cash and short-term investments	11,311,751		11,311,751	
Investment income due and accrued	19,192		19,192	
Uncollected premiums and agents' balances in the course of collection	161,680	2,011	159,669	
Deferred premiums, agents' balances and installments booked but deferred and not yet due	302,135		302,135	
Reinsurance:				
Amounts recoverable from reinsurers	72,954		72,954	
Other amounts receivable with reinsured companies	17,548		17,548	
Electronic data processing equipment and software	14,819	14,819		
Furniture and equipment	59,914	59,914		
Aggregate write-ins for other than invested assets	<u>118,561</u>		<u>118,561</u>	
Total assets	<u>\$ 21,406,496</u>	<u>\$ 76,744</u>	<u>\$ 21,329,752</u>	
<u>Liabilities, Surplus and Other Funds</u>				
Losses			\$ 2,006,740	(1)
Loss adjustment expenses			383,389	(1)
Commissions payable, contingent commissions and other similar charges			243,866	
Other expenses			111,658	
Taxes, licenses and fees			(1,629)	(2)
Current federal and foreign income taxes			(120,820)	(2)
Net deferred tax liability			1,029,866	
Unearned premiums			3,953,680	
Advanced premiums			175,356	
Amounts withheld or retained by company for accounts of others			<u>21,578</u>	
Total liabilities			7,803,684	
Unassigned funds		<u>\$13,526,068</u>		
Surplus as regards policyholders			<u>13,526,068</u>	
Total liabilities, surplus and other funds			<u>\$ 21,329,752</u>	

Underwriting and Investment Exhibit
for the Year Ended December 31, 2006

Statement of Income

Underwriting Income

Premiums earned		\$ 6,434,870
Deductions:		
Losses incurred	\$ 2,456,834	
Loss expenses incurred	988,841	
Other underwriting expenses incurred	<u>2,670,287</u>	
Total underwriting deductions		<u>6,115,962</u>
Net underwriting gain		318,908

Investment Income

Net investment income earned	\$ 569,588	
Net realized capital gains	<u>117,794</u>	
Net investment gain		687,382

Other Income

Net loss from agents' balances or premium balances charged off	\$ (28,430)	
Finance and service charges not included in premiums	<u>33,864</u>	
Total other income		<u>5,434</u>
Net income before federal income taxes		1,011,724
Federal income taxes incurred		<u>388,358</u>
Net income		<u>\$ 623,366</u>

Capital and Surplus Account

Surplus as regards policyholders, December 31, 2005		\$ 12,501,613
Net income	\$ 623,366	
Change in net unrealized capital gains	472,467	
Change in deferred income tax	(118,297)	
Change in nonadmitted assets	<u>46,919</u>	
Change in surplus as regards policyholders for the year		<u>1,024,455</u>
Surplus as regards policyholders, December 31, 2006		<u>\$ 13,526,068</u>

Reconciliation of Surplus as Regards Policyholders
from December 31, 2002 through December 31, 2006

Surplus as regards policyholders, December 31, 2002, per Examination \$ 8,211,891

	<u>Gain in Surplus</u>	<u>Loss in Surplus</u>	
Net income	\$ 3,294,783	\$	
Change in net unrealized capital gains	2,809,849		
Change in net deferred income tax		828,768	
Change in nonadmitted assets		47,286	
Aggregate write-ins for gains in surplus	<u>85,599</u>		
Totals	<u>\$ 6,190,231</u>	<u>\$ 876,054</u>	
Net increase in surplus as regards policyholders			<u>5,314,177</u>
Surplus as regards policyholders, December 31, 2006, per Examination			<u><u>\$ 13,526,068</u></u>

COMMENTS ON FINANCIAL STATEMENT ITEMS

(1) Losses and Loss Adjustment Expenses

Based on an analysis by a Casualty Actuary for the California Department of Insurance, the Company's loss and loss adjustment expense reserves as of December 31, 2006 were found to be reasonably stated and have been accepted for purposes of this examination.

The Company does not maintain documentation to support its reserves for Adjusting and Other (A&O) Expenses. It is recommended that the Company maintain documentation to support its A&O reserves in accordance with the National Association of Insurance Commissioners (NAIC) Annual Statement Instructions.

The Company did not establish a liability for excess of statutory reserves over statement reserves for its other liability line of business as required by California Insurance Code (CIC) Section 11558. The deficiency was immaterial and no examination adjustment was made. It is recommended that the Company comply with CIC Section 11558 in all future financial statements.

(2) Taxes, Licenses, and Fees Current Federal and Foreign Income Taxes

The Company reported federal income taxes and taxes, licenses, and fees receivable as a debit liability in its Annual Statement. It is recommended that the Company properly report federal income taxes and taxes, licenses, and fees in accordance with NAIC Annual Statement Instructions.

SUMMARY OF COMMENTS AND RECOMMENDATIONS

Current Report of Examination

Comments on Financial Statement Items – Losses and Loss Adjustment Expenses (Page 9): It is recommended that the Company maintain documentation to support its A&O reserves in accordance with the National Association of Insurance Commissioners (NAIC) Annual Statement Instructions. It is recommended that the Company comply with California Insurance Code (CIC) Section 11558 in all future financial statements.

Comments on Financial Statement Items – Taxes, Licenses, and Fees and Current Federal Income and Foreign Income Taxes (Page 9): It is recommended that the Company properly report federal income taxes and taxes, licenses, and fees in accordance with NAIC Annual Statement Instructions.

Prior Report of Examination

Comments on Financial Statement Items – Bonds, Preferred Stocks and Common Stocks (Page 9): It was recommended that the Company comply with Statements of Statutory Accounting Principles (SSAP) No. 26, paragraph 8, SSAP No. 32, paragraph 21, and SSAP No. 30, paragraph 9 of the NAIC Accounting Practices and Procedures Manual. The Company is now in compliance.

Comments on Financial Statement Items – Losses and Loss Adjustment Expenses (Page 9): It was recommended that the Company establish a reserve for Adjusting and Other Expenses in the future. In addition, it was recommended that the Company comply with CIC Section 11558. The Company is not fully in compliance.

ACKNOWLEDGMENT

The courtesy and cooperation extended by the Company's officers and Merced Mutual Insurance Company's employees during the course of this examination are hereby acknowledged.

Respectfully submitted,

_____/S/
Kyo Chu, CFE
Examiner-In-Charge
Senior Insurance Examiner
Department of Insurance
State of California